STATE OF MAINE
PUBLIC UTILITIES COMMISSION

Docket No. 96-388

February 6, 1997

NEW ENGLAND TELEPHONE & TELEPHONE COMPANY AND NYNEX CORPORATION
Proposed Joint Petition for Reorganization Intended to Effect the Merger with Bell Atlantic Corporation

ORDER (PART II)

Welch, Chairman; NUGENT and HUNT, Commissioners

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I. INTRODUCTION AND SUMMARY

We hereby grant to New England Telephone and Telegraph Company d/b/a NYNEX ("NET" or "NYNEX") the approvals required by Maine law to consummate a merger with Bell Atlantic subject to two conditions. First, NYNEX must comply with the 14-point "competitive checklist" in section 271 of the federal Telecommunications Act of 1996 by September 30, 1997. Second, NYNEX must maintain, for at least four years, an average level of capital spending in Maine comparable to the average level spent over the past four years and NYNEX must also propose, for Commission review and approval, benchmarks to ensure that Maine remains at the forefront of telecommunications technology and service. So long as NYNEX accepts those conditions, "the reorganization is consistent with the interests of [NYNEX's] ratepayers and investors."

On July 3, 1996, NET filed a joint petition with NYNEX Corporation (NET's parent) under 35-A M.R.S.A. § 708 for approval of a merger between NYNEX Corporation and Bell Atlantic Corporation. The merger constitutes a reorganization of NET under 35-A M.R.S.A. § 708(1)(A). 35-A M.R.S.A. § 708(2)(A) requires Commission approval of any reorganization of a public utility. To obtain approval, the applicant must show that "the reorganization is consistent with the interests of the utility's ratepayers and investors." In prior merger cases, the Commission has ruled that this standard is satisfied if the rates or service to customers of the utility will not be adversely affected by the transaction.

We issue this Order in two parts. Our Order (Part I), issued on December 31, 1996, stated our conclusion and the conditions we attach. This Order (Part II) explains the reasons for approving the merger and for imposing the conditions.

We find, with the two conditions described below, that the merger meets the statutory standard and should be approved. Section 708(2)(A) allows us to attach conditions to the approval for the purpose of protecting the interests of ratepayers.

II. MERGER APPROVAL - POSITIONS OF THE PARTIES

A. NYNEX's Position

NYNEX states that the proposed merger: (1) is fully consistent with the interests of the utility's ratepayers and investors as required under 35-A M.R.S.A. § 708; (2) will benefit ratepayers by facilitating improved service quality at competitive cost through a broader array of features, functions and services; and (3) is not likely to harm actual or potential competition. NYNEX states that the conditions proposed by Staff, the Public Advocate (OPA) and others are unnecessary, contrary to Commission policy and inconsistent with the interests of the utility's ratepayers and investors. Therefore, NYNEX does not believe that any change in its rates under the Alternative Form of Regulation (AFOR) adopted for NYNEX in Docket No. 94-123 is needed as a result of the merger with Bell Atlantic, and that Staff's and the OPA's proposals are, in effect, attempts to change the AFOR by including a sharing mechanism that has already been explicitly rejected by the Commission.

Other positions taken by NYNEX in response to other parties' positions are described below.

B. Staff's Position

Staff recommends, as a condition of the merger, that the productivity offset used in establishing rates in NYNEX's AFOR plan should be increased by 0.25%, 0.5% and 0.5% over the course of the next three AFOR price changes, which would result in a cumulative addition to the productivity offset of 1.25% at the end of the third year. In their direct testimony, Staff witnesses Kania and Cowie proposed this condition to capture savings from the merger while recognizing, through the phase-in of the productivity offset increase, that those savings will be achieved gradually as the combined entity meshes its management and operational functions. Staff argued that there will be significant benefits arising from the merger, including merger savings of perhaps $200-$300 million per year, additional savings resulting from the adoption of "best practices" of the two companies, and improved marketing of high-value added services by the merged Bell Atlantic. Further, Staff asserted that absent a change in the productivity offset, the merger savings benefits will inure almost completely to the benefit of the companies' shareholders. Staff argued that under 35-A M.R.S.A. § 708, the Commission is required to find that there are no adverse effects to ratepayers in order to approve a merger, citing *Bangor Hydro* and *Greenville Water Co.*[1] Staff stated that its cumulative 1.25% adjustment is equal to less than one-half of their estimate of Maine's share of the overhead savings that will result from the merger.

At the hearing, the Staff witnesses stated that the cumulative 1.25% increase in the productivity offset under the AFOR was necessary to offset risks to ratepayers resulting from the merger's adverse effect on competition and that it no longer argued that the proposed adjustment was intended to capture the net cost savings of the merger. Staff argued that the merger will not be "pro-competitive," and that the merger's impact on competition is an adverse effect to ratepayers that must be considered under 35-A M.R.S.A. § 708. Staff witness Kania stated that, under section 708, the Commission could apply any condition that is within the Commission's powers under the statute. Staff witness Kania recommends that the 1.25% productivity factor adjustment should take effect within the AFOR because that is the system under which NYNEX's rates are currently regulated in Maine.

Staff witness Kania testified that in his opinion the NYNEX/Bell Atlantic merger was not an exogenous event under the AFOR, but that the federal Telecommunications Act of 1996 has all of the attributes of an exogenous event. Staff witness Kania stated that "Tel Act `96 created a circumstance in which the removal of Bell Atlantic makes more of a difference than it might have before." Thus, as a result of the federal

[1] *See* full cites in Part III below.

Telecommunications Act and reduced competition resulting from the merger, Staff proposed a cumulative 1.25% increase in NYNEX's productivity offset.

While Staff recommended an increased productivity offset to compensate for diminished competition, Staff's quantification of its recommended cumulative 1.25% increase in the productivity offset appears to be based on a sharing of the estimated cost savings resulting from the merger.

C. OPA's Position

The OPA argued that it is entirely appropriate to make an adjustment in order to flow through the benefits of the merger in the context of the AFOR. OPA recommended approval of the merger only if the Commission orders a condition that explicitly passes on an appropriate share of the gain generated by the merger to NYNEX customers in Maine. OPA witness Selwyn claimed that NYNEX misled the Commission during the AFOR case about the possibility of a merger and that the Commission might have increased the productivity factor had it been advised of the potential economies achievable through the merger.

The OPA proposed two ways in which the Commission could ensure that NYNEX's customers in Maine share the economic gains generated by the merger. First, the Commission could reduce NYNEX's rates in Maine based on an allocation of the difference between market and book values, so that NYNEX customers in Maine receive a portion of the benefits that will be generated by the merger. OPA witness Selwyn stated that the Commission can calculate the benefits of the merger by determining the difference between the net book value of NYNEX assets in Maine and the portion of the total value of the transaction that is attributable to NYNEX of Maine. Dr. Selwyn estimated that amount to be about $518.8 million ($333.1 million on an intrastate basis). Dr. Selwyn estimated that the ratio of NYNEX of Maine's implied market value ($661.1 million on an intrastate basis) is about double book value ($328.0 million on an intrastate basis). Dr. Selwyn stated that, under the *Democratic Central Committee* case, discussed in Part V of this Order, ratepayers are entitled to receive about $333 million over a period of 5 years, which he states would result in a reduction in NYNEX's revenue requirement in Maine of about $79.8 million.

Second, the OPA argues that the Commission could reduce NYNEX's revenues in Maine under the AFOR. OPA argues that the operational savings generated by the merger would inevitably trigger a rate case and reduced rates under ROR regulation. The OPA proposed that the Commission should ensure that any economic benefits that would be flowed through under ROR regulation will be returned under the AFOR (or be superimposed on the AFOR through an auxiliary rate adjustment mechanism) in order for the effect of the merger to be consistent with: (1) the policy under 35-A M.R.S.A. § 9103 of keeping rates at least equivalent to ROR regulation-based rates, and (2) the "ratepayer interest" standard in section 708.

OPA witness Selwyn calculated that the ratepayers' fair share of the merger's cost savings and efficiencies is equal to $70.038 million. Dr. Selwyn stated that the resulting savings, expressed as an annuity with a term of 5 years, should be reflected for each of the next 5 years as a downward adjustment of $16.796 million per year to the AFOR price cap applicable to NYNEX's non-competitive services in Maine, and should remain in effect for 5 full years.

Dr. Selwyn stated that this adjustment would be implemented in the same manner as a Z-adjustment for certain exogenous changes, as permitted under the AFOR. He agreed, however, that his proposed adjustment does not actually qualify as an exogenous change under the AFOR because the merger is not "totally outside the control of NYNEX." Dr. Selwyn recommended, nevertheless, that the Commission revisit and revise the AFOR to reflect the merger's benefits, as a condition for its approval of the merger.

D. NYNEX Responses

In rebuttal to Staff's proposal, NYNEX argued that no change to the AFOR is warranted as a result of the merger. NYNEX argued that the merger with Bell Atlantic does not harm actual or potential competition. NYNEX further states, however, that even if Staff's competitive claims had merit, a further adjustment of the AFOR is unwarranted and contrary to the spirit and logic of the AFOR. NYNEX claims that the Commission adopted an AFOR because rate-of-return (ROR) regulation carries with it pernicious attributes that would only be aggravated by the emergence of competition. NYNEX states that the Staff's proposal to increase the productivity factor is inconsistent with the Commission's AFOR Order because the level of expected competition was never a predicate for the AFOR or a factor in the selection of the appropriate productivity factor argued and that the PRI itself, rather than competition, would flow back any efficiency gains.[2] NYNEX claims that the Commission’s 4.5% productivity factor is "one of the highest, most aggressive productivity offsets of any price cap plan in the nation." Further, the AFOR's productivity factor was designed to protect customers and give NYNEX strong incentives to be more efficient. NYNEX witness Dinan testified that the "Staff would now penalize NYNEX for doing exactly what the Commission has encouraged NYNEX to do."

NYNEX argued further that Staff's position should be rejected because: (1) the AFOR was designed to reflect actual experience in Maine, to be relatively aggressive compared to other states and to improve the reality and perception of Maine as an attractive climate for investment, and that the Staff's position undermines these purposes; (2) the type of "single-issue" ratemaking proposed by Staff ignores possible offsetting

[2]NYNEX claims that the Commission in the AFOR Order concluded that there likely would be no meaningful competition during the period the AFOR was in effect. In fact, the Order states only that there is relatively little competition at the time of the Order.

costs, including the effect of significant business risks resulting from enactment of the federal Telecommunications Act of 1996; (3) Staff's phase-in of the 1.25% increase in the productivity offset mischaracterizes the effects of the merger synergies and ignores the Commission's purpose in establishing a 5-year review period for the AFOR; and (4) Staff's proposal is, in effect, an attempt to change the AFOR by including a sharing mechanism that has already been explicitly rejected by the Commission.

In rebuttal to OPA witness Selwyn's recommended "market-to-book value" adjustment to NYNEX of Maine's rates, NYNEX witness Heitmann stated that Dr. Selwyn's theory is unreasonable and its adoption would be irrational: because NYNEX's assets are not being sold, Bell Atlantic is not paying a premium. Rather, the transaction is structured as a stock-for-stock exchange of shares between Bell Atlantic and NYNEX shareholders and there will no windfall to shareholders. More generally, NYNEX witness Heitmann stated that a market-to-book ratio above 1.0 can result from many different factors related to investor expectations of the firm and the industry. Finally, Mr. Heitmann stated that Maine did not use the approach recommended by Dr. Selwyn in the GTE/Contel merger proceeding.

In rebuttal to OPA witness Selwyn's contention that the AFOR plan should be amended to flow back all merger benefits in order to comply with the requirement of 35-A M.R.S.A. § 9103 that ratepayers under an AFOR should be no worse off than under ROR regulation, NYNEX argued that Dr. Selwyn's contentions are wide of the mark because the Commission, in its NYNEX AFOR Order, found that the productivity factor itself would accomplish that goal. In that Order, the Commission found that the 4.5% productivity offset provides "substantial benefits to customers" and determined that the Commission:

> will not initiate rate investigations against NYNEX for at least five years. If NYNEX increases its sales or reduces its costs by more than the PRI it keeps the extra profits.

NYNEX argued further that undermining the AFOR's incentive provisions would harm both ratepayers and investors. Finally, NYNEX notes that the perceived threat of a windfall to shareholders is not an immediate concern because it will be three years after the merger is consummated before the expected cost savings exceed the merger implementation charges and the transaction becomes cash-flow positive, and the Commission may review the issue of benefits during its AFOR review in 2000.

III. MERGER APPROVAL - LEGAL STANDARDS

The proposed merger of NYNEX Corporation (the parent corporation of NET) with Bell Atlantic Corporation constitutes a reorganization of NET under 35-A M.R.S.A. § 708(1)(A). 35-A M.R.S.A. § 708(2)(A) requires Commission approval of any reorganization of a public utility. Under that section the Commission may approve a reorganization only if the applicant shows that the reorganization "is consistent with the interests of the utility's ratepayers and investors."

In *Bangor Hydro-Electric Company and Stonington and Deer Isle Power Company, Joint Application to Merge Property, Franchises and Permits and for Authority to Discontinue Service*, Docket No. 87-109, Order Approving Stipulation and Merger (November 10, 1987) and *Greenville, Millinocket and Skowhegan Water Company, Application for Authorization to Sell Utility Property to Wanakah Water Company and to Discontinue Service*, Docket No. 92-250, Order Approving Stipulation (December 15, 1992), we found that the approval requirements of section 708 are met if the rates or service to customers of the former utility will not be adversely affected by the transaction. Thus, the merger should be approved if the total benefits flowing from the merger are equal to or greater than the detriment or risk causes for both the ratepayers and shareholders of NYNEX.

As discussed in Part V below, the Public Advocate has made two arguments that require us to consider the applicability of two other legal standards in this case. The OPA argues first that 35-A M.R.S.A. § 9103 (from the AFOR chapter, 35-A M.R.S.A.

§§ 9101-05) requires us to flow through benefits arising from the merger. The OPA also argues that under the principles of *Democratic Central Committee of the District of Columbia v. Washington Metropolitan Area Transit Commission*, 485 F.2d 786 (D.C. Cir. 1973) the Commission should flow through increases to the value of NYNEX's stock that result from the merger. We discuss the possible application of these legal standards in Part V.

IV. MERGER APPROVAL - DETERMINING WHETHER THE BASIC STANDARD HAS BEEN MET

As discussed above, we must determine whether the merger is "consistent with the interests of ratepayers and shareholders" by determining whether the benefits at least equal the detriments of the merger, i.e., that ratepayers and shareholders will not be harmed.

No party appears to contest the fact that the merger will result over time in large cost reductions. NYNEX witnesses Dinan and Heitmann described a number of benefits that will result from the merger. Among those benefits are:

1. An expense saving to the combined entity that will reach $600 million annually by the third year after the merger.

2. Reductions in annual capital expenditures of $250 million because of combined purchasing efficiencies.

The combination of these two effects results in cash savings that are expected to increase to more than $850 million per year. The Public Advocate witness Binz estimated that the merger will result in net savings of more than $2 billion for the merged company in net present value over the first 6 years.

While the extent of those benefits is undisputed by the parties, their distribution between ratepayers and shareholders and the timing of any distribution was a major focus of the parties' analyses of whether the merger is consistent with the interests of ratepayers, and of the Staff and Public Advocate proposals for conditions of approval.

The Advocacy Staff and the Public Advocate have asserted that the major detrimental effect of the merger is the diminution of competition in Maine that results from the loss of Bell Atlantic as a potential competitor to NYNEX. For the reasons discussed later in this section, we do not find that this potential detriment is sufficient to outweigh the potential benefits of the merger. However, we do agree that to find that the merger is consistent with the interests of ratepayers (i.e., that the benefits equal or outweigh the detriments), it is essential that ratepayers realize at least some portion of the benefits of the merger. We differ, however, from the Public Advocate and Staff on the timing of when ratepayers should realize benefits and the mechanism for their recovery.

The evidence shows that the costs and benefits of the merger do not occur simultaneously, and that there are no net benefits until some time after the merger occurs. NYNEX will experience large "startup" costs due to the implementation of the merger totaling about $700-$900 million during the first 3 years following the merger. Ratepayers, however, will be insulated from those costs by the operation of the AFOR. The AFOR is designed to ignore actual cost and revenue changes; rate changes are instead based on indexes that reflect national inflation and NYNEX's expected productivity in Maine. Both inflation and productivity affect NYNEX's costs, but NYNEX has no control over inflation. It does have some control over productivity, but the 4.5% productivity offset is set as a goal and does not track actual achieved results.

The AFOR will be in effect for at least the next 3 years. During that period, NYNEX customers' rates will be insulated from the up front costs of implementing the merger. Indeed, if the inflation index (GDP-PI) is less than 4.5%, NYNEX's rates will decrease in Maine even while the new Bell Atlantic (and NET-Maine, as part of the merged entity, NET d/b/a Bell Atlantic) will be incurring the up front costs associated with the merger.

By the time the yearly cost savings exceed the yearly merger implementation costs, the current AFOR agreement, which runs for five years, will have expired. At that time, the Commission must decide whether it will continue the AFOR, and, if so, on what terms.

Ratepayers could benefit from the eventual net cost savings in at least three ways. First, even prior to the 5-year review, to the extent that NYNEX must respond to competitors by reducing its rates, it may be able to do so more readily because of its lower cost structure.[3] Second, at the time of the 5-year review we may examine the net cost savings resulting from the merger, or, more generally, NYNEX's productivity, and modify the productivity index if the AFOR is continued. NYNEX witness Heitmann agreed that the Commission may examine the cost savings resulting from the merger and that it has the power to flow them through to ratepayers when it re-examines NYNEX's AFOR in 2000.[4] Finally, because we are relying on the purported savings in approving the merger, in determining that the benefits outweigh any harm caused by the possible diminution of competition, we may consider imputing these savings if they fail to materialize.

We also consider the potential harm from the merger. Both the Commission's Advocacy Staff and the Public Advocate argued that the merger will diminish the benefits of local and interexchange competition in the newly expanded competitive local and interexchange markets by removing Bell Atlantic, which they

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[3]The wholesale/retail local service discounts and unbundled network service element rates set at TELRIC costs should provide substantial competitive pressure for NYNEX when resale and facilities-based providers begin offering local exchange service. We have already approved interconnection rates for one competitor and have arbitrated rates for another competitor. We expect both competitors to begin offering service in 1997.

[4]The Comission would have a comparable opportunity to require rate reductions to reflect savings under traditional ratemaking if the AFOR is terminated.

argue is the most viable and potent competitor in the NYNEX market. NYNEX argued that the merger is unlikely to diminish potential competition in Maine. NYNEX witness Taylor based his conclusion on an anti-trust analysis: in order to find that the merger will adversely affect competition in NYNEX's territory, there must be a perception that Bell Atlantic would enter that market and that NYNEX's pricing decisions would be constrained because of that perception. Dr. Taylor testified that Bell Atlantic should not be considered a potential competitor in Maine under anti-trust guidelines and that numerous other firms such as interexchange carriers, cellular companies and competitive access providers possess entry advantages superior to Bell Atlantic because they already operate and have facilities in Maine. In his rebuttal testimony be concluded:

> As long as there are other likely potential entrants at least as qualified as Bell Atlantic to provide telecommunications service in Maine, there can be no harm to competition if one potential entrant -- Bell Atlantic -- withdraws from the market as a consequence of the merger.

Staff and the Public Advocate presented numerous proprietary and non-proprietary exhibits to show that Bell Atlantic was a potential competitor of NYNEX and that Bell Atlantic was considered by NYNEX to be one of its most potent potential competitors. None of that evidence or exhibits related specifically to Maine. Staff went on to state that Bell Atlantic is in a unique position to be "NYNEX's most effective potential competitor . . . in Maine."

Based on the evidence before us, we find that it was likely that, absent the merger, Bell Atlantic would have been a competitor to NYNEX somewhere (probably in New York) for both local and interexchange services.[5] However, we cannot find that Bell Atlantic either would or would not have been either a local or interexchange competitor in Maine. One of Bell Atlantic's greatest advantages as a potential competitor to NYNEX is its relative proximity to NYNEX's territory. For Maine, that advantage is diminished because of Maine's location at the far end of NYNEX's territory from Bell Atlantic's service territory. Bell Atlantic may have significant advantages in NYNEX's territories over other potential competitors that are LECs, but those advantages exist primarily in the New York metropolitan area portions of New York that are adjacent to New Jersey and Pennsylvania. Those advantages include name recognition, nearby work crews and service centers, and nearby switching or transport facilities, such as those that exist because of the New York-New Jersey "corridor exception."[6] Indeed, many of the internal plans of Bell Atlantic that are in evidence point in the direction of service in adjacent areas.

NYNEX, in its exceptions, protests that we should make no finding concerning the likelihood that Bell Atlantic, absent the merger, might have provided service in New York. NYNEX claims our statements are dicta, are not supported by the record. NYNEX also argues that the Commission should not "speculate" on an issue it claims is of "great consequence" in ongoing proceedings before the New York Public Service Commission and the Federal Communications Commission. We disagree. Our statements

[5] We cannot make a finding that Bell Atlantic would certainly have been a NYNEX competitor. Our hesitation is caused by the fact that most of the evidence produced by staff related to the Bell Atlantic-TCI merger under which Bell Atlantic would have obtained facilities within NYNEX's territory. If Bell Atlantic had acquired facilities in NYNEX's territory, it is highly likely that it would have become a competitor. After the Bell Atlantic-TCI deal fell through, any certainty disappeared.

[6] Under the Modified Final Judgment, Bell Atlantic and NYNEX were allowed to carry traffic and own facilities between NYNEX's New York City LATA and Bell Atlantic's Northern New Jersey LATA.

regarding the likelihood of Bell Atlantic's providing service to New York are relevant to our finding that it was not as likely to compete in Maine because of Maine's relative remoteness from Bell Atlantic territory. The finding is supported by numerous documents in the record, e.g., Bell Atlantic's "I Love N.Y." studies and NYNEX's study of potential competition from other RBOCs.

The advantages of proximity diminishes or disappears for Bell Atlantic once outside the New York metropolitan area. Relying on Bell Atlantic's description of the proposed Bell Atlantic-TCI merger, Staff argues that even if Bell Atlantic did not actually compete in Maine, NYNEX's "system wide" response to that competition would result in benefits throughout NYNEX territory. While this hypothesis is plausible, the actual likelihood is too speculative for us to consider without more concrete evidence.

Even if we assume, absent the merger, that Bell Atlantic would have competed in Maine, there is no substantial evidence to show that the absence of this one competitor will materially affect Maine ratepayers to the extent necessary to disapprove this merger. The significance of competition by Bell Atlantic in Maine is in part a function of the number and strength of other entities that choose to compete in Maine. If the number and strength of competitors turn out to be large, Bell Atlantic's absence will make little difference. If the number is small, that might indicate that the loss of Bell Atlantic is relatively more serious. It might also indicate that Bell Atlantic, like other potential competitors, might not have come to Maine for reasons related to the nature of the Maine market.

In summary, we approve the merger because we believe that the likelihood that the merger will benefit ratepayers (in the several ways described above) is at least equal to and may outweigh the relatively speculative detrimental effect that will be caused by the possible lessening of competition. Approval of the merger now, without making any rate reductions or AFOR adjustments (as discussed here and in Part V), does not mean that we will ignore the benefits or the possible anti-competitive result of the merger during the next AFOR review or when we comment to the Federal Communications Commission in the course of any interLATA request by NYNEX under section 271 of the Telecommunications Act of 1996.

V. SPECIFIC PROPOSED CONDITIONS

Both the Staff and the Public Advocate have proposed that the Commission attach certain conditions to the approval of the merger. Section 708(2)(A) states that the Commission has the authority to impose

> such terms, conditions or requirements as, in its judgment, are necessary to protect the interests of ratepayers. These conditions shall include provisions which assure the following: . . . .

The statute then lists nine conditions, including one (no. 9: "that neither ratepayers nor investors are adversely affected by the reorganization.") that is almost identical to the general approval standard. We do not view the attachment of conditions as a requirement of the statute. Although the statute provides that "these conditions shall include provisions which assure the following . . . ," the preceding sentence indicates that the Commission has the discretion to attach such conditions as it believes appropriate under the circumstances. Where the Commission cannot find that the reorganization will be in the interests of ratepayers and stockholders in the absence of conditions, it must impose appropriate conditions. If the Commission has found that a reorganization is in the interests of ratepayers and stockholders even absent conditions, it does not necessarily follow that it should refrain from imposing a condition if that condition will more nearly ensure that the Commission's conclusion was correct.

The parties in the case have proposed five conditions. All of them present efforts to ensure either that possible benefits do occur and that ratepayers receive a fair portion of those benefits or that possible detriments do not occur. Three of the conditions would be similar in effect in that they would all reduce rates immediately. However, each of those three is designed to achieve a different goal. The other two proposed conditions would attempt to ensure directly that a competitive market will exist in Maine and that the service quality in Maine provided by NET d/b/a Bell Atlantic remains high. We discuss each of the proposed conditions in turn.

A. Rate Reductions to Reflect Efficiency Gains

The Public Advocate has proposed that we adjust rates under the AFOR to reflect the net savings that NYNEX claims will result from the merger. The OPA specifically argues that such an adjustment is necessary to satisfy the requirement of section 708 that the reorganization be consistent with the interests of ratepayers and the policy under 35-A M.R.S.A. § 9103 of insuring that rates are no higher than those that would occur under rate-of-return regulation.

We have addressed many of the issues involved in these proposed conditions in the context of our discussion of the benefits and detriments of the merger. *See* Part IV. We have found that net cost savings are, in fact, likely to occur. However, because of high up-front costs, there are not likely to be net savings until the year 2000, when we must consider whether to continue an AFOR for NET. The timing of the net savings is relevant to both of the Public Advocate's claims, under section 708 and section 9103, for making adjustments. We agree that under 35-A M.R.S.A. § 9103 we must ensure that AFOR-regulated rates are lower than they would be under traditional ROR regulation. In this case, however, it appears likely that the up-front costs of the merger will outweigh the benefits of the merger for the next two or three years. As noted above (Part IV), NYNEX customers under the AFOR will not bear the costs of implementing the merger. By the time the yearly cost savings are likely to exceed the yearly merger implementation costs, it will be time for the 5-year review of the current AFOR agreement. As also discussed in Part IV, there are three possible ways in which customers will realize some of those benefits, and we believe that it is necessary to ensure that customers realize those benefits in some fashion because we have relied on them in determining that the merger is in the interest of ratepayers. However, neither the need to determine that the merger is in the interests of ratepayers (section 708) nor the requirement that rates under the AFOR be no higher than they would be under ROR (section 9103) requires that we must or should flow through those benefits now, rather than when they actually occur.

We also agree with NYNEX that the NYNEX merger with Bell Atlantic is an example of the cost-reducing activity that the AFOR was designed to encourage, and that capture of cost savings at this point in time would significantly impair the efficiency incentives under the AFOR. For the NYNEX AFOR to be credible, the Commission must adhere to its commitment to use price-cap regulation rather than traditional ROR regulation to set NYNEX's rates. If not, the AFOR cannot be expected to provide the strong efficiency incentive that we intended to provide to NYNEX. To provide a strong efficiency incentive, the AFOR allows NYNEX to retain efficiency gains that it can achieve during the term of the AFOR. Furthermore, the 4.5% productivity offset is designed to reflect the increased productivity that NYNEX should achieve in Maine under incentive regulation. We see no reason, based on the evidence before us, to weaken the incentives provided by the AFOR by requiring a flow through of some of the merger's benefits over the next several years.

The AFOR does not include a profit sharing component and its "exogenous change" component is narrowly written to include only those exogenous cost changes that: (1) have a very substantial and plainly disproportionate effect on NYNEX's costs and that are totally outside the control of NYNEX; or (2) jurisdictional separations changes and significant accounting changes mandated by regulatory agencies that apply only to NYNEX or the telecommunications industry. The Staff and OPA adjustments do not qualify as exogenous cost changes under the AFOR.

B. Rate Reductions to Reflect Increases in the Value of NYNEX's Stock

The Public Advocate separately recommends that we flow through to ratepayers the difference between market and book value to ratepayers over a 5-year period.

The OPA has based this argument on its reading of *Democratic Central Committee of the District of Columbia v. Washington Metropolitan Area Transit Commission*, 485 F.2d 786 (D.C. Cir. 1973) and *Casco Bay Lines v. Public Utilities Commission*, 390 A.2d 483 (Me. 1978). We do not agree with the OPA that *Democratic Central Committee* and *Casco Bay Lines* have any applicability to this merger. Those cases hold that when a utility's ratepayers have borne the risk of loss of a utility asset, they are entitled to the benefit of any gain (proceeds less net book value) on the sale of that asset. While the principles underlying *Democratic Central Committee* and *Casco Bay Lines* might reasonably be applied to other situations beyond the narrow facts of those cases, the current situation does not provide a reasonable analogy. There is no "gain" in the merger that could or should be shared with ratepayers. NYNEX has not sold any asset or otherwise divested any property that has been used to provide utility service; the merger involves only the transfer of shares of stock. NYNEX's telephone company assets remain in service providing service to customers. Moreover, NET ratepayers have not borne the risk of loss on any of the shares of either corporation (NET or NYNEX). The owners of the shares themselves bear the entire risk of a loss (or gain) in value of those shares. Under these circumstances, the threat to ratepayer interests that *Democratic Central Committee* and *Casco Bay Lines* were designed to address -- namely the threat that a utility would remove valuable utility assets from the reach of regulation without fair competition -- is completely absent.

C. Rate Reductions to Reflect Diminished Competition

Advocacy Staff argues that we should adjust the AFOR to reflect the diminution of competition. Staff's proposal is not based on any consideration of the level of savings resulting from the merger or any flow through of those savings.[7] As discussed in detail in Part IV, we have been unable to find that the merger will significantly diminish the level of competition in Maine. We were not able to find that it was likely that Bell Atlantic would have been a competitor or, even if it would have competed, that its absence will be harmful, in light of the opportunity for numerous other competitors. Even if an adjustment to rates were otherwise appropriate, neither the Staff nor the Public Advocate presented any evidence that attempts to quantify the harm resulting from the loss of Bell Atlantic as a Maine competitor. We therefore decline to make the adjustment proposed by Staff or any other adjustment to reflect the possible harm.

D. Conditioning Approval on the Competitive Checklist

Section 271 of the Telecommunications Act of 1996 sets requirements to be met by a Bell operating company in any state in its region where it provides intraLATA service prior to being allowed to provide interLATA services in that region. One of those requirements is a 14-point "competitive checklist" of interconnection services and access to facilities that a Bell operating company must offer.

Public Advocate witness Binz recommended that we "mitigate the negative effects of this merger on competition by requiring NYNEX and Bell Atlantic to meet the 'competitive checklist' . . . before the merger is permitted to go forward." Mr. Binz suggested we have authority under 35-A M.R.S.A. § 708(2)(A) to impose this condition, that the "precondition would simply rely on a decision that is going to be made anyway,"

[7] As discussed in Part II, Staff originally proposed to adjust rates to reflect the net cost savings that would result from the merger. During the hearing, however, Staff stated that its proposal to alter the productivity factor in the PRI was intended to compensate for the loss of Bell Atlantic as a competitor.

and that the condition would "not impose added burden on the carriers."

The evidence that Bell Atlantic would have been a competitor in Maine is slight. Nevertheless, there clearly remains some possibility that Bell Atlantic might have entered the Maine market or might have entered other NYNEX markets and thereby caused NYNEX to respond in ways beneficial to customers in Maine. Accordingly, we believe it is advisable to ensure that there is a fully competitive market in Maine by requiring that NET d/b/a Bell Atlantic meet the "competitive checklist" of 47 U.S.C. § 271.

We will require that NYNEX comply with the section 271 conditions, at least in Maine, as a condition of our own, independently from any determination the FCC must make to allow NYNEX to provide in-region, interLATA service. We also recognize the separate obligation we have under 47 U.S.C. § 271(c)(2)(B) to consult with the FCC on whether NYNEX has satisfied the competitive checklist. We will be prepared to do that consultation when NYNEX requests section 271 approval. We have recently opened an investigation in Docket No. 96-781 so that we may make our own determination to assist us in consulting with the FCC.

The requirements in the competitive checklist are essential to the development of intraLATA competition in Maine, and have the potential to create substantial benefits for users of both intrastate and interstate services. NYNEX of course has a substantial incentive to meet the checklist requirements; they are preconditions to NYNEX's ability to provide in-region interLATA services.

We believe the checklist requirements should be satisfied as a condition of the merger regardless of whether or not NYNEX chooses to pursue authority for in-region, interLATA service. Imposing that condition as a *pre*condition is impossible, however, because of the deadline in this case and the fact that NYNEX does not anticipate meeting the competitive checklist until later in 1997.

While we do not adopt the recommended condition as a precondition, we nevertheless adopt it on a going-forward basis as a measure designed to mitigate any possible negative effect that the merger may have on the emergence of local competition in Maine. We require that NET in Maine must meet the requirements of the competitive checklist by September 30, 1997. NET will be deemed to have satisfied this condition in Maine if (1) the FCC determines that it has met the checklist in the context of its proceeding pursuant to 47 U.S.C. § 271(d)(3), or (2) we conclude NYNEX has satisfied the checklist in our own investigation.[8] If NYNEX fails to meet this condition fully by September 30, 1997, we will consider amending the AFOR and related service obligations as remedies.

E. Reliability and Service Quality

Several parties questioned the possible effects of this merger on the quality, survivability and reliability of service provided to NYNEX customers in Maine. Some parties recommended that we impose conditions related to service quality on our approval of the merger.

NYNEX stated the merger will allow "more efficient and effective service," will enhance its ability to achieve the service quality levels as embodied in the Alternative Form of Regulation (AFOR) that we adopted for NYNEX in Docket No. 94-123, and through adopting the "best practices" of NYNEX and Bell Atlantic "will translate into improved service quality." A further guarantee of continued high levels of service quality, according to NYNEX, is that "[i]f the new corporation does not

[8] *Public Utilities Commission, Investigation of the Entry of New England Telephone and Telegraph Company d/b/a NYNEX into In-Region InterLATA Services Pursuant to 47 U.S.C. § 271*, Docket No. 96-781.

maintain high levels of service quality in Maine it will lose customers."

To the extent that additional investments are needed to maintain a service quality, NYNEX stated enhanced access to capital resulting from the merger "will support critical investment in advanced network switching technologies . . . and in the development of advanced fiber-optic electronics," thereby reducing the risk that Maine services may not be upgraded and improved. NYNEX described its infrastructure in Maine, using network reliability trouble report rates as a measure of the reliability of that infrastructure, as "the best" in NYNEX's service area, and "number one in the United States." NYNEX witness Dinan conceded, however, that "Bell Atlantic may in aggregate have a better service situation than NYNEX" because of NYNEX service quality problems in New York. NYNEX concluded that "Maine has a legitimate interest in ensuring that the *services* that telecommunications companies provide in Maine are not impaired and it may do so through the Commission's other ratemaking powers" without imposing conditions as part of our approval of the merger.

The Staff expressed concerns about network reliability and service quality in NYNEX's current Maine network, and raised the concern that the merger may degrade Maine's network reliability and service quality. Staff pointed to major service interruptions since 1989 and recommended implementation of a reliability outage measure under the AFOR. Staff also suggested that we may wish to consider increasing the AFOR Service Quality Index (SQI) rebate amounts to "provide the merged entity with the incentive to address the vulnerability of NYNEX's interoffice network."

Staff in its prefiled testimony recommended that we adopt as part of our approval of the merger "a performance standard that measures network reliability," set at a high level with a significant financial penalty.

NYNEX claimed as a result of new fiber optic SONET rings being constructed in Maine, "service interruptions of the magnitude experienced in the [1995] Freeport and [1996] Topsham outages will truly be a thing of the past." In its prefiled testimony, however, Staff stated that NYNEX cannot provide meaningful quantitative measurement of network reliability or survivability, or identify those particular investments that may affect reliability.

The OPA suggested that the merger may cause harm to Maine ratepayers from reduction or postponement of infrastructure investment, "particularly where competitive forces have not yet developed and where there is less market pressure or incentive to invest" in Maine compared to more metropolitan centers in the merged company's service area. OPA argued that incentives may exist for the merged company to "permit a decline" in service quality for ratepayers who have fewer competitive alternatives. OPA suggested that heightened awareness of service quality, through "reporting, monitoring and enforcement requirements," is necessary, and that we should consider enhancing SQI rebate incentives. The OPA recommended that we condition our approval of the merger to "ensure that the merger does not result in diminished capital budgets" for the Maine operation.

AT&T stated "NYNEX's exchange access services have consistently been of below-average quality and at above-average cost" nationally but did not provide any specific assessment of the access services provided by NYNEX in Maine.

While criticizing NYNEX for poor service quality trends generally, CWA stated that Maine service quality, reflected in repeat trouble reports, has improved during the past few years, and that in Maine NYNEX business office "understaffing is not as acute as elsewhere in the Bell Atlantic and NYNEX regions." CWA argued "the merged entity will pay even less attention to service quality," due to lessened competition and redirection of investment capital into other ventures of the firm.

We have no persuasive evidence to conclude that NYNEX's infrastructure and service quality in Maine are not currently satisfactory. We are concerned, however, about possible deterioration of the reliability, survivability, and quality of the services offered by NYNEX after the merger. The Maine Legislature has found that "a modern state-of-the-art telecommunications network is essential for the economic health and vitality of the State for improvement in the quality of life for all Maine citizens." 35-A M.R.S.A. § 7101(2). We expressed similar concerns about service quality as "a vitally important part of the AFOR" when we developed the SQI in the AFOR case. During the first year that the AFOR was in effect, NYNEX's service quality dropped below the SQI baseline in three of the 11 measurement areas currently in place. We are concerned that this decline in service levels may continue, perhaps aggravated by Maine's proportionally smaller share of the larger merged company. We are also concerned that Maine's relatively superior infrastructure and service quality may lead Bell Atlantic to concentrate its investment in other areas.

We constructed the AFOR SQI in mid-1995 as an incentive for NYNEX to retain its high levels of service, and have only one year of experience with its operation. We are reluctant to abandon or significantly modify the SQI structure or incentive levels at this time, without more compelling evidence that it is failing to achieve its objectives. The agreement by Staff and NYNEX to the structure of the reliability outage measure that we adopted in principle as part of the AFOR is a helpful enhancement. When the details of that measure are filed, assuming it is acceptable, we will implement it without delay.[9] We anticipate that the AFOR SQI, as strengthened by the addition of a measure specifically directed toward reliability, will provide NYNEX with the incentives needed to maintain Maine's high service quality and infrastructure levels.

[9] We request that NYNEX and the Staff file that measure in the AFOR case, Docket No. 94-123.

In addition to relying on the AFOR SQI as our mechanism for monitoring NYNEX's infrastructure and service quality, we will heighten our scrutiny of these issues through a number of other vehicles. We have directed the Staff to investigate NYNEX's network reliability separate from this proceeding because of recent widespread service interruptions. We have also decided to revise our rule governing Reporting Requirements for Local Exchange Carriers (Chapter 20) to include reporting of additional outage data. In that rulemaking, we will ensure that the information we need to monitor network reliability is continuously available.

In our Order adopting the NYNEX AFOR in mid-1995, we committed to an examination of Maine's telecommunications infrastructure in the context of the AFOR:

> During Spring 1997, we will commence a proceeding to review limited aspects of the AFOR. Although we do not at this time have any cause to believe that NYNEX's Maine infrastructure will be inadequate at that time, we must provide a method of reassuring the public that NYNEX is continuing to provide the infrastructure needed in Maine. This proceeding will consider whether NYNEX's infrastructure is adequate to fulfill needs caused by customer growth or demand growth for existing or new services. If we observe that NYNEX's infrastructure is inadequate to meet customer needs, the Commission has the right to require NYNEX to act to remedy the problem with such remedies to take effect by the December 1, 1997 date when the next annual AFOR rate adjustment is to be made, or to terminate the AFOR. We may also examine other remedies in other separate proceedings.

We will be mindful of Staff's recommendation that we consider the need to adopt additional service quality criteria as part of that proceeding.

To ensure that NET d/b/a Bell Atlantic continues to provide the telecommunications infrastructure investment necessary to support reliable, survivable, high quality service to Maine customers, we remain concerned that incentives exist for the merged company to delay, defer, or reduce such investment in Maine. While NYNEX's reliance on the effectiveness of the competitive marketplace to ensure continued high levels of service is encouraging, absent a specific condition to our approval of the merger we cannot at this time be completely confident that NET d/b/a Bell Atlantic will continue to invest in telecommunications infrastructure in Maine necessary to deliver continued high quality, reliable, advanced services to Maine customers. Thus, without imposing a specific condition in this regard, we cannot be assured that NET d/b/a Bell Atlantic will meet the requirements stated in 35-A M.R.S.A. § 708(2)(A)(9) "[t]hat neither ratepayers nor investors are adversely affected by the reorganization."

Accordingly, we require that NET d/b/a Bell Atlantic continue to invest in telecommunications infrastructure in Maine, for the next four years, at a rate comparable, on average, to the rate of investment for the calendar years 1992-1995. For the purposes of this condition, the rate will be measured by the ratio of new capital investment to existing gross plant investment. In addition, within 90 days after the effective date of this merger, NET d/b/a Bell Atlantic must file a proposal for appropriate benchmarks to permit the Commission to ensure that there continues to be an appropriate relationship between the services, facilities, infrastructure, and prices offered by NET d/b/a Bell Atlantic in Maine and those offered elsewhere in Bell Atlantic/NYNEX territory.

VI. CONCLUSION

We approve the merger because we believe that the likelihood that the merger will benefit ratepayers is at least equal to and may outweigh the relatively speculative detrimental effect that will be caused by the possible lessening of competition by the removal of one of the potential competitors to NYNEX. We also find that it is necessary to adopt the two conditions to our approval that are described in Parts V.D and V.E above.

Commissioner Hunt dissents from imposing the condition described in Part V.D (compliance with the competitive checklist) for the reasons stated in the attached Partial Dissent.

Dated at Augusta, Maine, this 6th day of February, 1997.

BY ORDER OF THE COMMISSION

Dennis L. Keschl
Acting Administrative Director

COMMISSIONERS VOTING FOR: Welch
Nugent

COMMISSIONER CONCURRING IN
PART AND DISSENTING IN PART: Hunt

This document has been designated for publication.

PARTIAL DISSENT BY COMMISSIONER HEATHER HUNT

I disagree with the majority decision to condition approval of the merger on NYNEX meeting the competitive checklist from the Telecommunications Act of 1996 by September 30, 1997. In my view, any condition on approval of the merger should be directly linked to the issues implicated by the merger. Congress created the checklist as a prerequisite for regional bell operating companies to offer in region interexchange service. The checklist's purpose and design have a tenuous relationship to the merger; as we concluded, the evidence presented in this case does not allow us to find that the merger will have any particular effect on the development of competition. Moreover, NYNEX has publicly stated its intent to comply with the checklist pursuant to the Telecommunications Act by September 1997. Duplicating the requirement and imposing a date subsequent to that announced by NYNEX does little, if anything, to foster competition.

NOTICE OF RIGHTS TO REVIEW OR APPEAL

5 M.R.S.A. § 9061 requires the Public Utilities Commission to give each party to an adjudicatory proceeding written notice of the party's rights to review or appeal of its decision made at the conclusion of the adjudicatory proceeding. The methods of review or appeal of PUC decisions at the conclusion of an adjudicatory proceeding are as follows:

1. Reconsideration of the Commission's Order may be requested under Section 1004 of the Commission's Rules of Practice and Procedure (65-407 C.M.R.110) within 20 days of the date of the Order by filing a petition with the Commission stating the grounds upon which reconsideration is sought.

2. Appeal of a final decision of the Commission may be taken to the Law Court by filing, within 30 days of the date of the Order, a Notice of Appeal with the Administrative Director of the Commission, pursuant to 35-A M.R.S.A. § 1320 (1)-(4) and the Maine Rules of Civil Procedure, Rule 73 et seq.

3. Additional court review of constitutional issues or issues involving the justness or reasonableness of rates may be had by the filing of an appeal with the Law Court, pursuant to 35-A M.R.S.A. § 1320 (5).

Note: The attachment of this Notice to a document does not indicate the Commission's view that the particular document may be subject to review or appeal. Similarly, the failure of the Commission to attach a copy of this Notice to a document does not indicate the Commission's view that the document is not subject to review or appeal.